

Letter of Findings: 04-20110404
Sales and Use Tax
For the Years 2008, 2009, and 2010

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Sales and Use Tax – Imposition – Exemptions.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-1-27; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-4-2; IC § 6-2.5-4-5; IC § 6-2.5-5-1; IC § 6-2.5-5-9; IC § 6-8.1-5-1; [45 IAC 2.2-4-11](#); [45 IAC 2.2-5-10](#); [45 IAC 2.2-5-14](#); [45 IAC 2.2-5-16](#); IC § 8-1-2-87.5; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Rhoads v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Sales Tax Information Bulletin 55 (May 1989).

Taxpayer protests the assessment on purchases of tangible personal property.

STATEMENT OF FACTS

Taxpayer is an industrial processor that has a facility in Indiana. Taxpayer applies liquid coatings to customer-owned steel and aluminum coils. This continuous process starts after the coil is unwound, cleaned, pretreated, coated, cured, and re-wound. Thereafter, coated coils are banded, covered, and placed on pallets for shipment back to its customers.

The Indiana Department of Revenue ("Department") conducted a sales/use tax audit for tax years 2008, 2009, and 2010. Pursuant to the audit, the Department determined that Taxpayer did not pay sales tax on certain purchases of tangible personal property, including, but not limited to, natural gas, water, packaging supplies, and labeling materials. The Department's audit thus assessed use tax on the grounds that Taxpayer did not pay sales tax or self-assess and remit the use tax on certain purchases of tangible personal property, which Taxpayer used for its business.

Taxpayer timely protested the assessments. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition – Exemptions.

DISCUSSION

The Department's audit assessed use tax on certain purchases where Taxpayer did not have documentation showing sales tax was paid at the time of the purchases. Taxpayer, to the contrary, claimed that it was entitled to various exemptions outlined in IC § 6-2.5 and [45 IAC 2.2-5](#).

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoads v. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id.; USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Id. A taxable retail transaction occurs when (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

In general, all purchases of tangible personal property by persons engaged in the processing or refining of tangible personal property are taxable. [45 IAC 2.2-5-10](#)(a). Tangible personal property means personal property that: (1) can be seen, weighed, measured, felt, or touched; or (2) is in any other manner perceptible to the senses. IC § 6-2.5-1-27. Tangible personal property also includes electricity, water, gas, steam, and prewritten

computer software. Id.

An exemption from use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." Id. at 100-101.

A. Natural Gas and Water.

As mentioned above, sales of utilities, including gas and water, are specifically designated as sales of tangible personal property ("retail transactions") and, therefore, subject to sales/use tax. Nonetheless, purchases of utilities are not subject to sales/use tax if a purchaser can demonstrate that it qualifies for:

- (1) an exclusion outlined in IC § 6-2.5-4-5(c)(3), which rests on determining that the purchaser's supplier is a "public utility" and that the purchaser predominantly (if not separately metered) uses the utilities in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture; or
- (2) a partial exemption under IC § 6-2.5-5-5.1 pursuant to the Department's Sales Tax Information Bulletin 55 (May 1989) ("Information Bulletin 55").

The Department's audit determined that Taxpayer, as an industrial processor, was qualified for a partial exemption pursuant to Information Bulletin 55. The Department's audit allowed Taxpayer a partial exemption (at estimated 85 percent) on its purchases of the natural gas and water. Taxpayer, to the contrary, claimed that it was entitled to a 100 percent exemption outlined in IC § 6-2.5-4-5(c)(3). Alternatively, Taxpayer asserted that, even if it was not entitled to the 100 percent exemption, it was entitled to more than 85 percent exemption under IC § 6-2.5-5-5.1.

1. Is Taxpayer Qualified for the Exclusion Outlined in IC § 6-2.5-4-5(c)(3)?

Taxpayer claimed that its purchases of the natural gas and water were predominantly used in its processing operation and, thus, were qualified for the exclusion outlined in IC § 6-2.5-4-5(c)(3). The Department's audit determined that IC § 6-2.5-4-5(c)(3) was not applicable because Taxpayer's supplier was not a public utility.

IC § 6-2.5-4-5, in pertinent part, states:

- (a) As used in this section, a "**power subsidiary**" means a corporation which is owned or controlled by one (1) or more public utilities that furnish or **sell** electrical energy, **natural** or artificial **gas, water**, steam, or steam heat **and which produces power exclusively for the use of those public utilities.**
- (b) **A power subsidiary or a person engaged as a public utility is a retail merchant making a retail transaction when the subsidiary or person furnishes or sells** electrical energy, **natural** or artificial **gas, water**, steam, or steam heating service to a person for commercial or domestic consumption.
- (c) Notwithstanding subsection (b), a power subsidiary or a person **engaged as a public utility is not a retail merchant making a retail transaction** in any of the following transactions:
 - (1) The power subsidiary or person provides, installs, constructs, services, or removes tangible personal property which is used in connection with the furnishing of the services or commodities listed in subsection (b).
 - (2) The power subsidiary or person sells the services or commodities listed in subsection (b) to another public utility or power subsidiary described in this section or a person described in section 6 of this chapter.
 - (3) The power subsidiary or person **sells** the services or commodities listed in subsection (b) **to a person for use in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture.** However, this exclusion for sales of the services and commodities **only applies if the services are consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are separately metered for the excepted uses listed in this subdivision, or if those sales are not separately metered but are predominately used by the purchaser for the excepted uses listed in this subdivision. (Emphasis added).**

[45 IAC 2.2-4-11](#) explains:

- (a) In general, **the furnishing of electricity, gas, water, steam or steam heating services by public utilities to consumers is subject to the state gross retail tax.**
- (b) A power subsidiary or a person engaged as a public utility in furnishing or selling electrical energy, natural or artificial gas or mixtures thereof, water, or steam or steam heating services to a person for domestic or commercial consumption shall be a retail merchant in respect thereto, and the gross income received therefrom, shall constitute gross retail income of a retail merchant received from a retail transaction.
- (c) The gross receipts of power subsidiaries on public utilities from the furnishing or selling of gas, electricity, water, or steam are subject to the state gross retail tax. The tax applies to the total receipts of such power subsidiary or public utilities for services furnished or sold, irrespective of whether the actual net charge is based upon actual consumption, a flat rate charge, or a minimum charge. The tax is borne by the consumers.
- (d) The term "public utilities" as used in this regulation [\[45 IAC 2.2\]](#) means **any organization which is engaged in the furnishing or selling of electricity, natural or artificial gas or mixtures thereof, water,**

steam or steam heating, and having the right of eminent domain or subject to government regulation in connection with the furnishing of public utility services. The term includes governmental units and not-for-profit organizations which furnish public utility services. (Emphasis added).

Information Bulletin 55 further illustrates:

Indiana Code 6-2.5-4-5 provides that a power subsidiary or person engaged as a public utility is not a retail merchant making a retail transaction when it sells electrical energy, natural or artificial gas, water, steam, or steam heat to a person for use in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture. (Note: **This exclusion does not apply to utilities used in processing another's product.** E.G., one who mills machinery for another does not receive this exclusion.) Sales and use tax is imposed when property is acquired from a retail merchant in a retail transaction. Since this law excludes utility sales, for the listed uses, from being retail transactions, they cannot be subject to sales or use tax. **This exclusion applies when the sales of the utility are (1) by public utilities or power subsidiaries, (2) used in manufacturing, production, etc., and (3) either separately metered or predominately used in an excluded manner.**

PUBLIC UTILITIES

A public utility is defined as **any organization engaged in furnishing electrical energy, natural or artificial gas, water, steam, or steam heating and having the right of eminent domain or subject to government regulation in connection with the furnishing of public utility services.** Only electricity, natural or artificial gas, water, steam, and steam heat are included. Fuel, fuel oil, gasoline, coal, liquid propane, and any other utility not listed are not included in this exclusion.

USED IN MANUFACTURING, PRODUCTION, ETC.

Use in manufacturing or one of the other listed production processes begins at the point of the first operation or activity constituting part of an integrated production process and ends at the point that the production process has altered the item to its completed form, including packaging, if required. To qualify for the exemption, the listed utility must be consumed as an essential and integral part of an integrated process which produces tangible personal property. In general, utilities will meet this test to the extent that they power equipment used as an essential and integral part of an integrated production process. Therefore, the provision of [45 IAC 2.2-5-8](#) through 2.2-5-11, which govern the exemption for production equipment, shall determine whether utilities used to power equipment are exempt under Indiana Code 6-2.5-4-5. For example, utility service used to power computers which control production machinery is exempt. In addition, utility service used to operate equipment which controls the environment so production can occur is exempt.

...

Manufacturing or production does not include maintenance, servicing, or repairing of equipment, or testing, handling, shipping, receiving, or storing the finished product. (Utilities used for testing during the production process are exempt.) Utilities used for general space heating or air conditioning, general lighting (including security lighting), movement of goods outside the production process, in offices, or in providing for employee health or comfort are taxable.

...

SEPARATELY METERED OR PREDOMINATELY USED

The exclusion from sales tax only applies if non-taxable utilities are separately metered, if they are predominately used by the purchaser for the excepted uses. "Predominately used" means more than 50 [percent] of the utilities are consumed for the exempted use. Each meter is considered separately to determine if the utility measured is exempt. If a user has multiple meters, they will not be lumped together for a determination of predominate use, but each will be considered separately. **(Emphasis added).**

Accordingly, a taxpayer may claim that its purchases of utilities are not subject to sales/use tax only when the taxpayer (1) purchases utilities from a public utility, (2) uses the utilities in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture ("excluded manner") and (3) has either separately metered or predominately used the utilities in the excluded manner listed.

Taxpayer explained that it purchased natural gas and water from a supplier ("Vendor") – a company which previously owned the facility where Taxpayer operates. Believing that IC § 6-2.5-4-5(c)(3) was applicable, Taxpayer stated that:

The auditor overlooks IC § 8-1-2-87.5, which states that [a]ny person, corporation or other entity that... is engaged in the transportation of gas solely within this state on behalf of any end use consumer... is a public utility[.]

Referring to a pending court case, Taxpayer asserted that Vendor was a party in that case, in which the Indiana Utility Regulatory Commission ("IURC") determined that Vendor is a public utility pursuant to IC § 8-1-2-87.5. Thus, Taxpayer invited the Department to adopt the IURC's determination and to apply IC § 6-2.5-4-5(c)(3). By doing so, Taxpayer believed that its purchases of the natural gas and water were 100 percent exempt because it predominantly used the natural gas and water in its coating process which was similar to a manufacturing process.

Taxpayer's reliance is misplaced. Whether Vendor is a person engaged in transportation of gas and subject

to Title 8 of the Indiana Code, Utilities and Transportation, is beyond the scope of this tax protest. Specifically, [45 IAC 2.2-4-11](#)(d) and Information Bulletin 55 explain, in relevant part, that "public utilities" means any organization which is engaged in the furnishing or selling of natural gas or water, and "having the right of eminent domain or subject to government regulation in connection with the furnishing of public utility services." Taxpayer was not Vendor, whose dispute is currently pending in court and yet unresolved, nor did Taxpayer provide any documentation demonstrating that Vendor met the requirements outlined in [45 IAC 2.2-4-11](#)(d) and Information Bulletin 55.

Additionally, IC § 6-2.5-4-5(c)(3) is only applicable when a purchaser uses the utilities "in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture." Specifically, Information Bulletin 55 explains that "[t]o qualify for the exemption, the listed utility must be consumed as an essential and integral part of an integrated process which produces tangible personal property" and "[t]his exclusion does not apply to utilities used in processing another's product." Taxpayer, an industrial processor, applies coating materials to the customer-owned coils. Thus, the Department must respectfully decline Taxpayer's invitation to apply IC § 6-2.5-4-5(c)(3).

2. Is Taxpayer Qualified for an Exemption under IC § 6-2.5-5.1?

The Department's audit determined that Taxpayer, as an industrial processor, was qualified for a partial (estimated 85 percent) exemption pursuant to Information Bulletin 55. The Department's audit, in relevant part, noted that:

Page 3 of [Information Bulletin 55] allows for a partial exemption to the extent utilities are used in industrial processing; taxpayer states that they believe 85-90 [percent] of the gas bill is used in processing operations. Auditor will reduce utility purchases by 85 [percent] and will assess use tax on [the remaining 15 percent of the utility purchases].

Taxpayer, to the contrary, asserted that the auditor incorrectly estimated 85 percent of the utility purchases were directly used in Taxpayer's processing operation. Taxpayer stated, in its protest letter, that "98.4 [percent] of [its] natural gas usage is directly used in its processing operation." Taxpayer, thus, maintained that "even if [it] does not qualify for 100 [percent] exemption under Ind. Cod § 6-2.5-4-5(c)(3), it is still entitled to a 98.4 [percent] exemption under Ind. Code § 6-2.5-5.1."

IC § 6-2.5-5.1 provides:

- (a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat.
- (b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.
- (c) A refund claim based on the exemption provided by this section for electrical energy, natural or artificial gas, water, steam, and steam heat may not cover transactions that occur more than eighteen (18) months before the date of the refund claim.

Information Bulletin 55, in relevant part, further explains:

PARTIAL EXEMPTIONS

Any user who does not meet the predominate use test and **industrial processors may qualify for partial exemption under Indiana Code 6-2.5-5.1 for utilities which are directly consumed by the purchaser in the direct production of tangible personal property in the purchaser's business** or manufacturing, **processing**, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. Fuel oil, gasoline, coal and other types of fuel may also be exempt to the extent they are directly consumed by the purchaser in direct manufacturing or production. This exemption will only be for the percentage of utilities qualified, NOT for the entire amount of billings. All sales tax must first be paid to the utility and a claim for refund with documentation submitted to the department on a calendar year basis. (**Emphasis added**).

At the administrative hearing, Taxpayer further explained that in preparing for the hearing, its employees conducted utility studies on its usage of natural gas and water for one of the audited years and determined that it used 98.1 percent of natural gas and 98.87 percent of water in its process operation. The information, however, became available only after Taxpayer protested the assessment and was submitted to the Department at the hearing. Since Taxpayer provided additional documentation demonstrating its actual usage rather than relying on an estimate, the Department will review the additional information and verify Taxpayer's allowable exempt purchases of the natural gas and water in a supplemental audit.

In short, Taxpayer's protest of the purchases of natural gas and water is sustained to the extent that the Department verifies Taxpayer's claimed exempt usage. Upon verification, the Department will adjust the percentage of Taxpayer's exempt purchases of natural gas and water accordingly.

B. Packaging Supplies.

The Department's audit assessed Taxpayer additional use tax on the purchases of packaging supplies for which Taxpayer did not pay sales tax at the time of its purchases. Taxpayer, to the contrary, asserted that it was

entitled to the exemption outlined in IC § 6-2.5-5-9(d) and [45 IAC 2.2-5-16](#)(d)(1).

IC § 6-2.5-5-9(d) states:

(d) Sales of wrapping material and empty containers are exempt from the state gross retail tax **if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds. (Emphasis added).**

[45 IAC 2.2-5-16](#) explains:

(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

(b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [[45 IAC 2.2](#)] provided an exemption for wrapping materials and containers.

(c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

(2) Deposits for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.

(3) Returnable containers sold empty for refilling.

(d) Application of general rule.

(1) Nonreturnable wrapping material and empty containers. **To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:**

(A) The purchaser must add contents to the containers purchased; and

(B) The purchaser must sell the contents added. (Emphasis added).

Taxpayer asserted that it "sells coatings which it applies to steel and aluminum coils on behalf of its customers." Taxpayer further explained that its "resulting product [e.g., the coated coils] is placed in nonreturnable containers for shipment to its customers." Thus, Taxpayer maintained that it was "entitled to an exemption for the nonreturnable packaging materials in which it ships its products to its customers."

Taxpayer's reliance is misplaced. [45 IAC 2.2-5-10](#)(a), in pertinent part, states that:

An industrial processor, as defined in [IC 6-2.5-4-2](#), is one who:

(1) acquires tangible personal property owned by another person;

(2) provides industrial processing or servicing, including enameling or plating, on the property; and

(3) transfers the property back to the owner to be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing, assembling, constructing, refining, or processing.

IC § 6-2.5-4-2(c), in relevant part, further states that:

Notwithstanding any provision of this article, a person is not making a retail transaction when he:

(1) acquires tangible personal property owned by another person;

(2) provides industrial processing or servicing, including enameling or plating, on the property; and

(3) transfers the property back to the owner to be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing, assembling, constructing, refining, or processing. **(Emphasis added).**

In this instance, Taxpayer acquired the steel and aluminum coils owned by its customers; Taxpayer provided industrial processing or servicing, including applying coatings on its customers' steel and aluminum coils; and Taxpayer transferred the steel and aluminum coils back to its customers to be sold by its customers. Thus, Taxpayer is an industrial processor pursuant to [45 IAC 2.2-5-10](#)(a) and IC § 6-2.5-4-2(c). The statute specifically excludes an industrial processor from being considered as a retail merchant making a retail transaction when the three statutory requirements are met. Thus, the Department is not able to agree that "Taxpayer sells coatings which it applies to steel and aluminum coils on behalf of its customers."

In short, Taxpayer's purchases of packaging supplies were taxable. Since Taxpayer did not pay sales tax at the time of its purchases, use tax is properly imposed.

C. Labeling Materials.

The Department's audit assessed use tax on Taxpayer's purchases of labeling materials, including items used for bar coding, paper for invoicing and packing slip information, and adhesive plastic folders used to hold the items mentioned. Taxpayer asserted that it was entitled to an exemption generally under [45 IAC 2.2-5](#).

Presumably, Taxpayer was referring to [45 IAC 2.2-5-14](#) although Taxpayer did not articulate its reference specifically.

[45 IAC 2.2-5-10](#), in relevant part, states:

(a) In general, all purchases of tangible personal property by persons engaged in the processing or refining of tangible personal property are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to

manufacturing machinery, tools, and equipment used in direct production. **It does not apply to materials consumed in production or to materials incorporated into the tangible personal property produced.** Additionally, **the exemption provided in this regulation [45 IAC 2.2] extends to industrial processors.** An industrial processor, as defined in [IC 6-2.5-4-2](#), is one who:

- (1) acquires tangible personal property owned by another person;
- (2) provides industrial processing or servicing, including enameling or plating, on the property; and
- (3) transfers the property back to the owner to be sold by that owner either in the same form or as a part of other tangible personal property produced by that owner in his business of manufacturing, assembling, constructing, refining, or processing.

...
(d) Pre-processing and post-processing activities. "Direct use" begins at the point of the first operation or activity constituting part of the integrated production process and **ends at the point that the processing or refining has altered the item to its completed form, including packaging, if required.**

...
(g) "Have an immediate effect on the tangible personal property being processed or refined." Machinery, tools, and equipment used during processing or refining which have an immediate effect upon the tangible personal property being processed or refined are exempt from tax. Component parts of an exempt unit of machinery and equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of the manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not, of itself, mean that the property "acts upon and has an immediate effect on the tangible personal property being processed or refined". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

...
(j) Managerial, sales, and other nonoperative activities. Machinery, tools, and equipment used in managerial sales, research and development or other nonoperational activities are not directly used in processing or refining and, therefore, are subject to tax. This category includes, but is not limited to machinery, tools, and equipment used in any of the following activities: **management and administration**; selling and marketing; **exhibition of manufactured or processed products**; safety or fire prevention, equipment which is not essential and integral to the production process; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; **and shipping and loading. (Emphasis added).**

[45 IAC 2.2-5-14](#) also explains:

- (a) The state gross retail tax shall not apply to sales of any tangible personal property **which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale** by such purchaser in the business of manufacturing, assembling, refining or **processing**.
- (b) The exemption provided by this regulation [\[45 IAC 2.2\]](#) applies **only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of** manufacturing, assembling, refining or **processing**. This regulation [\[45 IAC 2.2\]](#) does not apply to persons engaged in producing tangible personal property for their own use.
- (c) This regulation [\[45 IAC 2.2\]](#) does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-5(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the production of tangible personal property.
- (d) The purchase of tangible personal property which is to be **incorporated by the purchaser as a material or an integral part** is exempt from tax. "**Incorporated as a material or an integral part into tangible personal property for sale by such purchaser**" means:
 - (1) That the material must be **physically incorporated into and become a component of the finished product**;
 - (2) The material must **constitute a material or an integral part of the finished product**; and
 - (3) The tangible personal property must be **produced for sale by the purchaser**.
- (e) Application of general rule.
 - (1) Incorporation into the finished product. **The material must be physically incorporated into and become a component part of the finished product.**
 - (2) Integral or material part. The material must constitute a material or integral part of the finished product.
 - (3) The finished product must be produced for sale by the purchaser. **(Emphasis added).**

In this instance, Taxpayer claimed that it was entitled to an exemption on its purchases of the labeling materials because the labeling materials were attached to the coated coils. To support its claim, Taxpayer submitted photos demonstrating its use of the labeling materials.

Taxpayer's documentation, however, showed that the labeling materials were attached to plastic-like

materials, which were used to wrap/cover the coated coils after Taxpayer completed its coating process. The labeling materials were not physically incorporated into and did not become a component part of the coated coils. Additionally, the labeling materials, which contained bar code, the customer's name, order number, coil number, weight, coating date, were used to identify the coated coils, which were wrapped by the plastic-like wrapping materials, to be shipped to its customers. While the labeling materials may be considered essential to the conduct of Taxpayer's business because their use is required by practical necessity, but they do not have an immediate effect upon the tangible personal property being processed. The labeling materials thus were used for managerial purpose, i.e., inventory control, and/or other nonoperative activities, i.e., shipping. Therefore, the Department is not able to agree that Taxpayer is entitled to an exemption on its purchases of the labeling materials.

Since Taxpayer did not pay sales tax at the time of its purchases, use tax is properly imposed.

FINDING

Taxpayer's protest is sustained, in part, and respectfully denied, in part.

Pending the Department's verification in a supplemental audit review, Taxpayer is sustained on its protest of the purchases of natural gas and water. Upon verification, the Department will adjust the percentage of Taxpayer's exempt purchases of natural gas and water accordingly. Taxpayer's protest of Part B and Part C is respectfully denied.

Posted: 02/29/2012 by Legislative Services Agency

An [html](#) version of this document.